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## Asia Team of Flying Geese: The Rise of China and Implications for HKSAR

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### Abstract

China is a member of the Asia team of flying geese, except that it is a jumbo. Growth of China will change global relative prices but would not cause global deflation. China is becoming an engine of growth for Asia through more regional trade. Asia is becoming more competitive through regional trade integration but the Asian economy is still fragmented due to weak financial systems, which fail to protect property rights over the long run. Asia's competitiveness comes from its structural and institutional factors and does not depend much on exchange rate and monetary policy. Asia has all the ingredients for sustained growth and prosperity but needs to build the institutional foundation for globally competitive regional cooperation.

Hong Kong has all the institutional strengths China and other Asian economies wish to have, such as efficient supply chain management, robust banks and stock markets, and independent legal system. These strengths reduce transaction costs in Hong Kong and have turned Hong Kong into a transaction-intensive service economy. Hong Kong's competitiveness derives primarily from its low transaction costs. The factor costs in Hong Kong are high and largely fixed. This is why the Hong Kong economy is vulnerable to fluctuations in trading volume due to regional and global business cycles. When trading volume is high, Hong Kong can pay high prices for its fixed factor inputs but when trading volume is low, Hong Kong has troubles in financing its expensive factor inputs even with its quite flexible factor markets. Hong Kong performed well during and after the Asian financial crisis thanks to its strong market infrastructure. But the future of Hong Kong depends on how well it can expand trading volume while lowering its factor costs through further integration with both China and the international economies. This is a great challenge to the Hong Kong government, business, and people since the place, although strong in free markets, was traditionally weak in strategic planning, leadership and coordination in relation to regional economic integrations with the Mainland China, Asia and the global economy.

## 1. The questions

China is rising but it is only catching up with Japan, Korea, Hong Kong and other members of the Asia team of flying geese. There is a long way for China to go before it can reach the OECD level of development. But already China's take-off has created concerns to its neighbours. In my view people in Hong Kong and the rest of Asia are too pessimistic on this. What I am going to present is fundamentally an optimistic perspective. I will use Hong Kong as an example to discuss the pains and sweets brought about by the rise of China. There are strong bases for optimism in Hong Kong and Asia and I will explain why by looking at a few questions of longer-term concern:

- The first question we need to know is what is happening in China. Why is China so successful in attracting FDI? What is special about China? What are China's biggest problems at the present?
- The next question is the impact of China's growth on Asia and the global economy and the responses. Is China causing deflation? Is China hurting growth and trade of other Asian economies? How do China's neighbours response to the rise of China? How does Hong Kong response.
- The last question is about policy, especially exchange rate policy as it has domestic and international implications. Should China revalue its RMB? Should China float its RMB? I can only discuss the core issues related to the RMB debate as the issue of exchange rate policies and management requires a separate paper.

## 2. What is special about China?

What is happening in China now is in fact what happened in Europe and U.S. over the last five hundred years and in Asia during the last fifty years. We all remember that five hundred years ago China was the leader in the global economy (Maddison 2001). China and Asia fell behind only during the modern period of capitalistic economic development. But we are now coming back and catching up quickly and firmly. Asia's long march towards capitalistic economic development is characterized clearly by the flying geese model. The forerunners of the Asia team of flying geese, Japan and some Asian tigers including Korea have already reached the OECD level of per capita GDP. But they represent only a small portion of Asia's population. As shown in Figure 1 the Asia team of flying geese is enlarging rapidly with the coastal China reaching the level of per capita GDP similar to that of Malaysia and Thailand. China is just another member of the Asia team of flying geese, except that it is a big jumbo by population.

China's labor force is larger than the labor force in all developed economies. China's GDP is second only to US if we use purchasing power parity prices. At current prices, China's GDP is one fourth of Japan's and one tenth of U.S.'s. For some products, like toys and shoes, China's market share could be as large as 80% of the world.

China is young and maturing. I am a typical baby-boomer in China, born right after the great famine following the Great Leap Forward during 1958-61. People in my age group have to face with life time competition in China and even overseas simply because of the sheer number. But we are now at the most productive age. In fact, China's population profile is almost exactly like Japan's in 1976, with working age population as much as 70%, the highest in the world (PRB 2002).

China is opening up, in a big way, and voluntarily after closing for about five hundred years since the end of the Ming dynasty. Global capital is now moving to China through FDI (see Figure 2). Foreign corporations are competing not with China, but among themselves. All major global producers of automobiles are now in China. Most importantly, capitalistic economic institutions are replicated in China with the help of Hong Kong and a large number of returning overseas Chinese students, like me.

In summary, China is catching up by learning from its neighbors' experiences. The only difference is that China has almost unlimited supply of unskilled labor and a very large pool of skilled labor and well trained engineers, which have kept China's wages and prices from rising. This means that China fits the Lewis model of unlimited supply of labor (Lewis 1954).

These structural and institutional factors are behind the steady flows of FDI into China. We have to remember that China had almost zero inflows of FDI when it was opened in 1978. As foreign investors built up their capital stocks in China, the FDI flows are likely to overshoot in the early period of China's effective opening. That overshooting period started in 1992 and is reaching the peak now. During the overshooting period, the scale and speed of FDI flows into China have been very impressive. In 2002 China's FDI flows reached \$53 billion, overtaking US as the most favored FDI destination (UNCTD 2002; Cheong and Xiao 2003).

China's current stock of FDI reached about US\$500 billion, which is close to one fifth of the stock for all developing countries and about one third the size of China's GDP. This amount is roughly equal to the increase of foreign capital stock in all developing countries during the twenty five years after the Second World War. Globalization in recent years has speeded up China's transformation.

Foreign investors have strong incentives to invest in China, because their investment there has low-risk and high-return. China has given relatively good protection to foreign assets by establishing laws for foreign invested firms, which are entirely separated and different from the outdated domestic laws. China also allows foreign investors to have 100% shares and complete control of their factories in China from the start of its reform. On the one hand, China's cheap land and labor would enhance foreign companies' competitiveness in the global markets. On the other hand, China's large and growing domestic markets diversify foreign companies' revenue sources and secure sustainable profits.

FDI in China is catching up and overshooting but is not really a miracle. FDI flows into China is about 6.4% of the global total, which is slightly higher than China's share of global export at about 5% but much lower than China's share of global GDP in terms of purchasing power parity prices at 11.3%. About one quarter to an half of China's FDI may be disguised domestic capital making round-trip return to take advantage of favorable tax treatment and property rights protection to foreign capital (Xiao 2004).

In 2001 on per capita basis, China's FDI flow is only \$37, lower than the average of \$42 for the rest of developing economies. Again on per capita basis, China's FDI stock is \$309 in 2001, lower than the average of \$478 for the rest of developing economies (Cheong and Xiao 2003).

Figure 3 grouped China's provinces into three regions by size of the FDI flows. It shows that 85% of China's FDI and 89% of China's foreign trade are in China's 9 provinces. The top 9 provinces are all in China's east coast. They are "the China" as seen and reported in today's headlines. But this rapidly growing region only has one third of China's population. The middle 12 provinces have a large gap with the top 9 in performance but have 50% of China's population. The bottom 10 provinces are in China's western region and they are among the poorest in Asia.

What are the main impacts of China's growth on the global economy? In my view, China is changing global relative prices because the entry into global market places of one fifth of the mankind has led to necessary adjustments in the global specialization of production. This adjustment means deflation in manufacturing products and inflation in knowledge, raw materials, energy, and advanced services.

Among all explanations of the Asian financial crisis, the adjustment of relative prices seems to be the most convincing. Around 1997 it became clear that China (and possibly a few other major developing economies or regions such as India and Russia) was about to be fully integrated into the world economy. This implies an addition of more than one fifth of the world's labour forces to the world market for producing exportable manufacturing products. Given the much slower rise in income and demand for these manufacturing products in China, it is inevitable that the relative prices for all products, which can be manufactured en masse in China, have to fall.

This relative prices adjustment hit directly on the manufacturing bases across Asian economies and forced investors to lower their expected returns. The downward adjustment of expected returns generated quickly financial losses through the volatile financial markets across Asia and even in the world. The panic and wealth losses during the crisis seem inevitable since someone has to absorb the losses due to the relative prices adjustment which has to come sooner or later.

However, in monetary terms China is too small to contribute much to a global deflation. China's share of world GDP at current prices is only about 4% to 5% and China's share of world exports is roughly the same. For deflation to happen, it requires savings to be much larger than investment. China's savings is indeed larger than investment and China

is indeed exporting net savings to U.S. This leads to slight deflation pressure in China in the last few years but the amount of China's net export of savings is trivial on a global scale.

In the last few months of 2003 and early 2004, China started to see a little inflation of less than 3% due to rising prices in raw materials and food. Economists are debating hotly if the Chinese economy is overheating or not now. My view is that certain sectors and regions may have excessive investment but the economy as whole is still suffering from large amount of surplus labor and capital. So inflation if there is any, would be short-lived and localized, representing more of relative price adjustments. This is particularly so since the private sector has already become the main driving force for China's employment and production.

The rapid growth of one fifth of mankind, following the proven model of modern capitalistic economic development as practiced in Europe, US, Japan and the Asian tiger economies will trigger a global change towards not only more competitive production but also much higher living standards for people in both the developed and less developed countries. This impact on global production and consumption style is the reason for my optimism. More significantly, China is not alone in this global development trend. Add India and the rest of developing Asia, what we are seeing now is that more than half of the mankind is joining the global team of flying geese. This will open gigantic possibilities for global realignment of resources. That means investment opportunities, and risks as well.

### 3. Responses to China's rise from Asia and the rest of the world

Once we are clear that the key change brought about by the growth of China is the changes in global relative prices, it is easy to understand the reactions from the rest of the world:

- Expected returns for the past investment in labour intensive manufacturing need to be adjusted downward. This has happened already during the Asian financial crisis.
- Shareholders need to absorb residual losses and sunk costs. The stock markets are the main mechanism for absorbing losses and have done well during the Asian financial crisis and the tech bubble.
- Producers need to adjust their strategies. The MNCs are the leaders in this.
- Consumers are enjoying cheaper and better manufacturing products.
- Economies need to re-position themselves in the value chain, with China as a new partner.

As shown in Figure 4, the adjustments are already happening now. China and its Asian neighbours are gaining market shares in manufacturing exports and FDI at the costs of mature economies. Asian tiger economies and multi-national corporations are doing well on economic integration with China, lowering costs and gaining competitiveness. Figure

4 show that the developed countries lost 11 percentages in their market share of manufacturing exports. China gained 2.8%. The six Asian tigers gained 3.1%. Asia as a whole gained 7.3%. The developing countries as a whole gained 9.9%.

China's impact on the global consumption will also be consistent with the global relative price changes. China's demand for energy and raw materials are rising (Newton and Subbaraman 2002; Anderson and Hu 2003). According to China's National Statistical Authorities, half of the world's cements are poured on China's ground together with one third of the world's steel in 2003.

China is under reconstruction and is also becoming a world factory. This has important implications for developing economies. Products made in China with parts and design from elsewhere is making the middle-class life style affordable to emerging working classes in developing countries. This is a unique phenomenon brought about by modern capitalistic economic development, which makes the ordinary consumers the king, instead of producing for king.

China is becoming an engine of growth in the region by trading more with its neighbors and having net imports from its neighbors. As shown in Figure 5, China's gross imports and exports is much larger with Asia than with the US and Europe together. China runs a small trade deficit with Asia but huge trade surplus with US (WTO 2002). China's trade deficits with Taiwan, Thailand, Malaysia, and Korea are very big. China imports a lot of parts and materials from his neighbors to make finished products and then export them to US and Europe. This regional trade integration based on modern supply chain management allows more efficient specialization and larger economies of scale. The regional integration in trade and production is progressing well and lays the foundation for further regional integration in capital market.

#### 4. Why does not surplus capital hire surplus labor?

The capital market and financial sector are the weakest parts in the Chinese and Asian economies. They caused problems in the global economy through a global mismatch in savings and investment. The U.S., with its strong financial system, attracts large capital inflows, which are used to finance its over-consumption and asset bubbles. Europe and Japan, with their ageing population, have accumulated a large amount of savings and invested them in the US market since the emerging markets are still regarded too risky. China and emerging markets are young and growing fast with high savings. But their under-developed capital markets cannot even digest their own savings. They are actually exporting net savings to US, which are then recycled back to the emerging markets as FDI. The problem is the co-existence of surplus capital and surplus labour at local, regional, and global levels because the capital markets fail to perform their functions well.

This is bad not only for the ageing population in the rich countries but also for the young generation in the poor countries. The two groups could have a great trade across borders and across generations if our capital markets are functioning as they are described in the textbook! I will not go into the details on the statistics that shows the puzzle of co-

existence of surplus capital and surplus labor in China, Asia, and the world (Cheong and Xiao 2003). China, Japan and many other Asian economies are famous for their persistent current account surplus, which means surplus savings or surplus capital. As I will discuss more, it is important to recognize that the problem with current account surplus is not about competitiveness in trade. Instead, it is about why surplus capital does not hire surplus labor, at local, regional, and global level. This I think is a more constructive and more effective way to think and deal with the issue.

Why does not surplus capital hire surplus labor? At the domestic level, it is because the banks are not effective in screening good projects and the stock markets do not serve the best companies. The regional and global markets do provide some alternatives to bringing capital and labor together such as through the FDI, offshore financial centers such as Hong Kong and Singapore markets, and international banking and capital markets. But these alternatives are much more costly and are limited in depth and scale. The root of the problem is the protection of property rights. Surplus capital will not hire surplus labor without proper protection of property rights. Financial systems are about the protection of property rights. Clearly the challenge to China and Asia is to improve the financial system and the protection of property rights so that our surplus capital can hire surplus labor.

This brings us to the issue of competitiveness of an economy. Based on the modern institutional economies, the competitiveness of an economy is correlated negatively with at least two kinds of costs: factor costs and broadly defined transaction costs. The factor costs of labour, land, and materials can be assessed with modern economics tools of supply and demand and are easy to understand. The transaction costs, on the other hand, are abstract but real and usually have not much to do with supply and demand. Transaction costs are costs of inadequate institutions and incentives and they are man-made costs that hinder mutually and socially beneficial exchange.

The transaction costs in China before 1978 were infinitively high, leading to virtually no market exchanges and incalculable individual and social losses. Hong Kong and Singapore, among many tiger economies, have maintained their competitiveness in the global markets largely because their low transaction costs more than offset their high factor costs. China's entry into WTO will reduce many artificially created transaction costs, which is essential for increasing China's competitiveness as well as for better integration of the Asian economy.

Asia has surplus capital and surplus labour. Asia also has cutting-edge technology in Japan, rich resources in ASEAN, rapidly growing markets in China and India, and world-class offshore financial services centres in Hong Kong and Singapore. But Asia needs more competitive domestic services sector that can reduce transaction costs. More specifically, China and Asia need efficient and timely distribution networks, efficient and safe banks, efficient and robust capital markets, efficient and reliable accounting services, and trusted and credible legal system, all of which now exist in Hong Kong!



Due to lack of these transaction costs reducing sectors, China and Asia's financial systems cannot perform well in its main functions of resource allocation, price discovery, risk management, and corporate governance. Our banking and capital markets are not efficient enough to channel our savings to those investments with good risk-adjusted returns. Our interest rates, PE ratios, and other key asset prices are not yet consistent with the long-term average market rates observed in the mature economies. We rely heavily on banks, leading to high and concentrated systematic risks and high NPL costs for the government. We encourage capital inflows and fear capital outflows, creating costs for risk management at the global-level. Our legal systems and corporate cultures cannot create incentives that can deter stealing while at the same time encourage socially beneficial risk-taking.

To improve the core functions of our financial system, we have to focus on protecting property rights. Hard-earned wealth from exporting can be destroyed without protection of property rights. Our strong real sector creates wealth but our weak financial sector destroys it. It is an irony that our super Asian household savers cannot afford to spend after the bubble bursts. We need to remember that financial system is a system to transact and protect property rights of all participants across time, place, border, and generation.

## 5. Debates about RMB exchange rate policy

Unfortunately most policy makers in the world worried more on short-term gains through exchange rate changes than on reforms in the property rights infrastructure and financial system. During the last five years, rumors and advises on depreciation or appreciation of RMB have always become headline news. It is difficult for any paper discussing about China and Asia economies not to address the exchange rate issues.

Ron McKinnon has written an excellent paper on China's exchange rate and balance of payment issues (McKinnon and Schnabl 2003). His paper is so timely and important that a top Chinese magazine led by the most famous Chinese economist Professor Wu Jinglian translated his paper as soon as it was sent out for circulation. McKinnon summarizes the economics of exchange rates and current account into two insights.

Insight one is the following: the on-going Current Account surplus is all about export of net savings and not necessarily about competitiveness. For example, Japan, China, and many Asian economies have exported net savings by running persistent Current Account surplus. On the other hand, the US over-consumption is financed through its Current Account deficit, which is corresponding to net savings by Japan, China, and others.

Insight two is the following: the exchange rate is about domestic inflation or deflation and not necessarily about competitiveness. For example, with HKD pegged to US dollar, Hong Kong has to make its structural adjustment through deflation or inflation. With Euro appreciating sharply against dollar now, Europe is likely to experience deflationary pressure. According to McKinnon, Japan is experiencing deflation partly because the yen has been under frequent waves of appreciation pressures. In my opinion, these two basic economics insights should become the guiding principles for policy-making.

McKinnon proposes twin hypotheses to explain the typical exchange rate issues in Asia and Latin America. The surplus savings problem in Asia is described as “conflicted virtue” (McKinnon and Schnabl 2003) and the over-consumption problem in Latin America is described as “original sin” (McKinnon and Schnabl 2003). The two problems however are symmetric and could be seen as twin hypotheses.

What is the “Conflicted Virtue” for Asian economies? Japan and other Asia countries including China hold large net savings in dollar assets. This is of course a virtue by traditional standards. However, under a floating exchange rate regime, they collectively cannot hedge their built-in exchange rate risks at low costs because their country has a large net foreign exchange assets position. When individually they prefer to hold domestic currency, such as yen or RMB, rather than dollar, collectively they depress yen or RMB interest rate to zero, creating domestic currency appreciation and domestic deflation.

What is “Original Sin” for the Latin American economies? Latin America countries hold large net dollar liabilities. They borrow too much and consume too much and that is a “sin” by traditional standards. Under a floating exchange rate regime, they collectively cannot hedge for built-in exchange rate risks at low costs since their country has a large net foreign exchange liabilities position. When individually they prefer to hold dollar, collectively they drive up domestic currency interest rate, leading to domestic currency depreciation and domestic inflation.

The problem with both Asia and Latin America is the built-in imperfection of markets under the floating exchange rate regime when a country has large net foreign assets or net foreign liabilities. Like in a severe bear market, it is hard to find optimistic people to bet with you at low costs when almost everyone is a bear.

Is there any solution to this problem of imperfect market? McKinnon, contrary to IMF, recommends that Japan and China should adopt an East Asian dollar standard to minimize exchange rate risks until Yen and RMB become global reserve currencies like the dollar and euro. Global reserve currencies would not have the problem of “conflicted virtue” or “original sin”. On the other hand, a country with large net foreign exchange liabilities may have no choices but letting its exchange rate to float. This is the standard IMF position, which prefers floating than fixing.

Now let’s look at the implications of McKinnon analysis for China. The key to eliminate persistent Current Account surplus in China is to reform China’s financial sector so that more savings could be channeled to good investment projects. Similar to inflation or deflation, nominal exchange rate adjustments are mainly about redistribution between debtors and creditors and are not really about changes in competitiveness. Given China’s large reserves, surplus in Current Account and large amount of surplus labor, it is possible and convenient for China to link RMB to dollar to minimize nominal exchange rate risks and allow its domestic price adjustments to absorb shocks. In another word, according to McKinnon insights, it is better for China to have low domestic inflation (or

relative price adjustments) than to have RMB revaluation. As to competitiveness, McKinnon insights would regard inflation, deflation, and exchange rate adjustments as monetary phenomenon, and so they should be neutral in the long run. Monetary policy cannot change real competitiveness, which is determined largely by structural and institutional factors.

The Chinese authority has repeatedly declared its intention to main a stable exchange rate policy under the existing managed float regime. Given the rising official reserves due to strong export, FDI, and inflow of speculative capital, China has so far not adjusted the RMB exchange rate. Instead, it has started to take advantage of the weak demand for foreign exchange by relaxing aggressively the capital account convertibility, encouraging capital outflows. The chief of China's State Administration for Foreign Exchange indicated recently that China may be able to achieve basic capital account convertibility in five to six years.

## 6. Hong Kong's responses to structural and cyclical shocks

Hong Kong is a good example for illustrating the McKinnon insight about deflation and exchange rate. Hong Kong economy has been hit by a series of structural and cyclical shocks since 1997 (Yam 2004):

- Volatility in growth and consumption (Figure 6)
- About 70% losses in property markets (Figure 9)
- 50% loss in stock markets (Figure 13)
- 15% drop in price level (Figure 9)
- an increase of unemployment rate from 2% to 7% (Figure 7)
- a change from a fiscal surplus to a fiscal deficit of above 5% of GDP (Figure 8)
- a significant capital flight (Figure 18 and 19)
- a narrowing interest margin and declining loan/deposit ratio for banks.

But the Hong Kong economy is anchored by a currency board linking HK\$ with USD (Figure 14), robust property rights and regulatory institutions, and little hope of bailout by the government. The private sector of Hong Kong is resilient with manageable problems in NPLs and corporate and individual bankruptcies (Figure 11 and 12) (Lai and Shi 2002; Shu 2002; Yu, Ho et al. 2003). Growth in trade is steady with large current account surplus thanks to integration with Mainland China (Figure 17).

Hong Kong's robust performance can be explained by two factors in addition to its good institutions and solid integration with the Mainland China. First, most relative prices in Hong Kong are flexible and adjusting quickly to re-gain competitiveness (Figure 10), except a much slower fall in civil servants' salaries. Second, the private sector is continuously adjusting in spite of a relatively young government with weak leadership.

Would a floating exchange rate or a re-peg do better for Hong Kong? How would the alternative monetary systems work? The critics did not spell it out. The size of the net benefits and costs of the alternatives are not clear. In fact, as soon as the Hong Kong economy started to recover in late 2003, Hong Kong dollar was under strong pressure of appreciation (Figure 14). The appreciation pressure on Hong Kong dollar may be largely due to the depreciation of U.S. dollar and the speculation on RMB appreciation but they are shocks Hong Kong has to deal with through flexible price adjustments. If Hong Kong adopts a floating exchange rate regime, the exchange rate volatility would probably add much more instability to the economy.

## 7. Why has Hong Kong been so competitive in the past?

Previously in this paper I have argued that the competitiveness of economies depends on at least two categories of costs: factor costs of labour, land, capital etc and transaction costs of using markets. I would like to add two more costs for analysing Hong Kong's competitiveness: the costs of transportation and communications and the coordination costs of using governments. The higher these costs, the higher the prices of locally produced products and services and the less competitive the local economy. Hong Kong's current economic malaise and past success illustrate this.

On factor costs, the prices for land and housing in Hong Kong are among the highest in the world due to limited supply (by natural endowment and by government control). Since most of the skilled workers and money in Hong Kong could move to anywhere in the world, the return to them has to be higher than any alternative they can get in the rest of the world. In deed, as shown in Figure 18 and 19, during 2000-2002, Hong Kong had large capital flight to take advantage of high returns in the U.S. stocks and bonds (Gerlach, Peng et al. 2003). Hence, salaries and interest rates for these mobile factors in Hong Kong are among the highest in the world. The wage for unskilled and immobile workers in Hong Kong is however low relative to that in the developed economies but much higher than that in the rest of China due to tight control on immigration and labour importation.

On transportation and communication costs in Hong Kong, thanks to its geographical endowment and past investment, Hong Kong has developed an excellent transportation and communication infrastructure except for its border traffic with mainland China. The transportation and communication costs cross Hong Kong-mainland China are sometimes much higher than those across the Pacific Ocean due to monopoly or a lack of coordination. For many years, a telephone call to Hong Kong's neighbouring cities in mainland China such as Shenzhen and Zhuhai costs five to ten times of a call to New York. There are only two border passes via land for people to move between Hong Kong and Shenzhen, which close before midnight until last year. Sending or shipping a package to Shanghai could be as expensive and time-consuming as to New York due to complicated custom-clearing procedures in China.

The transaction costs of using markets are very low in Hong Kong thanks to its inherited political, social, legal and regulatory institutions which are relatively transparent and

supportive to free markets. Government interventions and oligopoly situations do exist in some sectors in Hong Kong. We do observe high concentration ratios in a few sectors (such as supermarkets and telecom), high prices in a few products (such as fresh milk), and high government subsidies in a few areas (such as housing for low income and medical cares, housing subsidies covering about 40% of Hong Kong's households). However, on the whole, there are few artificial barriers to markets and transactions in Hong Kong. Almost everything could be traded or speculated in Hong Kong including for a time Snoopy from MacDonald. The low transaction costs per unit of market transactions have led to large volumes of transactions in Hong Kong. This is reflected in Hong Kong's GDP composition: 84% of its GDP is from the service sector which is related to trade, financial, and other transactions.

The coordination costs of governments before the handover are minimal. First, there is not much need for the colonial government to coordinate economic development either with the central government in Beijing or with the local governments in Shenzhen and Guangdong. Second, there was freedom but little democracy in Hong Kong before the handover. Little coordination is needed among the Hong Kong Government and the local community. The coordination costs of using governments have been rising rapidly after the handover and will continue to rise because of the "One-Country, Two-Systems" arrangement. In summary Hong Kong has been very competitive and successful mainly because of its low transaction costs.

## 8. Hong Kong during the crisis

The Asian Financial Crisis during 1997-1999 hit Hong Kong extremely hard as exemplified in the plunge of the stock market index, housing prices, growth, and employment. The financial crisis played out in two key dimensions: falling prices and shrinking volumes of transactions. Hong Kong is extremely vulnerable to both because of its heavy reliance on low transaction costs.

Hong Kong cannot compete with other economies on factor costs, which are determined largely by supply and demand. Instead, it has to compete on transaction costs, which are determined by institutional arrangements. With low transaction costs and high factor costs, Hong Kong businesses depend on much larger volumes of trade and financial transactions to maintain their profit margin and keep their competitive edge.

When the volumes of transactions are high, Hong Kong businesses can make profits even when their factor costs of labour, housing, and capital are high. This is because the key parts of the factor inputs (including labour, housing, and capital) for trade and financial transactions in Hong Kong are usually fixed costs that do not change much in tandem with the volumes of trade and financial transactions. In other words, the factor prices (such as the rental costs) in Hong Kong can have multiple levels of market equilibrium associated with various levels of trade and financial transaction volumes in Hong Kong.

Unfortunately the volumes of trade and financial transactions in Hong Kong and elsewhere in Asia dropped sharply and quickly during the Asian Financial Crisis. That

crippled Hong Kong's main mechanism of making money. When volumes are low, low transaction costs in Hong Kong do not help but high factor costs here hurt even more. Clean government, good regulatory and monitoring mechanisms, and a transparent legal system could not solve the problem of shrinking volumes and falling prices during the global or regional business cycles.

At the beginning of the crisis, the HKSAR Government and many observers failed to understand the important impact of the exacerbating problem of shrinking volumes of trade and financial transactions on the Hong Kong economy. They were far too optimistic when the crisis loomed. However, after the crisis hit Hong Kong, the HKSAR Government and the community at large were too pessimistic about the recovery. Hong Kong's GDP growth recovered abruptly and surprisingly when the volumes of trade and financial transactions went up in Hong Kong and elsewhere in China and Asia. The sharp turn around of GDP growth from -5% to +8% growth and rapid rise of Hang Seng Index from 6000 to 15000 in Hong Kong during 1998-2000, however, did not restore Hong Kong people's confidence about the future of its economy (Figure 6).

## 9. The future of the Hong Kong economy

The Asian financial crisis exposed Hong Kong's main weakness: high factor costs. The rapid development of Shanghai points out Hong Kong's another weakness: a lack of effective strategies, planning and coordination by the government.

As China deepens its economic opening and integration with the world economy, Hong Kong will continue to feel the deflationary pressure from cheap factor costs in mainland China (Ha and Fan 2002; Ha, Fan et al. 2003). In addition, it will feel the deflationary pressure due to the reduction of transaction costs in China. China's accession to WTO will soon open banking, financial, legal, accounting, retailing and other services sectors to foreign investment. As a result, the transaction costs of doing business in China will inevitably fall. That would help China to compete much more effectively with its comparative advantage of low factor costs.

Five year ago, most observers were making jokes on how to fill up the office buildings in Shanghai because the total newly constructed office floors were said to exceed the total stock in Hong Kong. Today, no joking, some of the prime office buildings in Pudong already enjoy occupancy rates higher than in Hong Kong. The prime hotels in Shanghai are now almost fully booked throughout the year. Shanghai is actively attracting Fortune 500 corporations while Hong Kong has yet to respond effectively. About four year ago Shanghai's Government decided to stop collect fees for crossing the bridges and tunnels linking Pudong (East of Huangpu river, a newly developed district of Shanghai) and Puxi (West of Huangpu river, old districts of Shanghai) while the HKSAR Government was considering to collect taxes for crossing the land border with China until a year ago. These contrasting behaviours of the Shanghai and Hong Kong governments point to a new problem for Hong Kong. The HKSAR Government seems not as effective as that of

Shanghai in mapping out development strategies and coordinating whether with the local community or with the central and local governments in mainland China.

At present, it seems unclear whether Hong Kong will be able to maintain its competitiveness for long. It depends on how the government and the local community will cope with the challenge of reducing the factor costs as well as the coordination costs of the governments. The transaction costs in Hong Kong are already very low. Little can be done to reduce them further but still a lot of efforts are necessary to keep the political, social, legal and regulatory institutions transparent and effective as Hong Kong integrates slowly with mainland China.

However Hong Kong can go a long way in reducing its factor costs through economic integration with Southern China, especially with Shenzhen. For example, if Hong Kong people could live in Shenzhen, their purchasing power could increase three to five times. Then it would be possible to reduce Hong Kong people's income by one third while still maintaining their current living standards. This may not be necessary for the high income people in Hong Kong but may be crucial for many low income people to maintain their living standards. With lower labour and housing costs, Hong Kong will be able to attract more business from mainland China and the world. Many Hong Kong people are doing this right now. With just a little more investment in infrastructure and better coordination with the Shenzhen Government, this could happen on a significantly larger scale and lower the factor costs in Hong Kong. This may be the only way to enhance the overall competitiveness of Hong Kong and the Southern China region including Hong Kong in the long run. Many people worry about the short-term impact of this adjustment on the housing prices and employment in Hong Kong and attempt to resist or slow economic integration of Hong Kong with Southern China. They think a slow integration could protect Hong Kong people at least in the short run. That is an illusion like a bubble. Hong Kong's housing prices may depend more on long-term prospects of Hong Kong than many of the short-term factors. New York, London, and Tokyo could all maintain high housing prices without a border to separate them from their neighbouring cities simply because they are all at the heart of the world's super economic regions.

Hence, the real challenge for Hong Kong is to help Southern China attract Fortune 500 multinational corporations and develop the region into one of the world's super economic regions. Without a solid industrial base in Southern China, Hong Kong's status as an international trade and financial centre would be shaky, depending on such factors as inconvertibility of the Chinese currency and the non-transparency of China's legal system. These multinational corporations, once settled in southern China, are not likely to relocate and are likely to create a cluster of foreign and domestic firms. On the other hand, the investment bankers in Hong Kong could relocate in just a few months to Shanghai. Some of them already stay longer in Beijing or Shanghai hotels than in their Hong Kong home. In principle, like New York, London, and Tokyo with their hinterlands, Hong Kong could develop and integrate with Southern China even if there were no borders between the two areas.

This economic integration needs a clear blessing from Beijing, courage and wisdom from Hong Kong, not just its government but also its people, and above all, cooperation of Southern China. The key in this integration process is to help Southern China reduce transaction costs while facilitate Hong Kong's reduction of factor costs. China's growing economy needs many Shanghai-scale centre of super economic region. Hong Kong could play such a leading role for Pearl River Delta as Shanghai did for the Yangtze River Delta.

The current "One-Country, Two-Systems" arrangement makes it difficult to coordinate economic development and policies among the governments of Beijing, Hong Kong and Southern China, at least in the short run. Also, since the political arrangement has been designed to protect the economic interest of local businesses and people after the handover, it makes it difficult to sacrifice the short run economic interest of some Hong Kong businesses and people in order to gain the long run prospect of Hong Kong. This means that there is a significant risk that Hong Kong could fail to improve its competitiveness through rational economic integration with Southern China. This risk is even bigger when considering China's imminent accession to the WTO. The WTO accession would certainly speed up Shanghai's development and leave Hong Kong much less time for adjustment.

Today Hong Kong is still the most important local economy within the PRC. Hong Kong's total foreign trade volume was as large as that of China (almost half of it is re-exports or re-imports relating to China) only a few years ago. Measured by market capitalization, half of Hong Kong's listed companies are either operating in mainland China or outside of Hong Kong. Hong Kong is fully integrated with the world economy except China. These first mover advantages not only provide Hong Kong with some cushion in the competitiveness game but also suggest that China and Hong Kong could hardly afford a slower economic integration.

Fortunately both Beijing and Hong Kong have now realized the importance of integrating Hong Kong economy with the Mainland economy. On 29 June 2003 Last year, Mainland and Hong Kong governments signed an agreement on "Closer Economic Partnership Arrangement (CEPA)" and was implemented on 1 January 2004 (An 2004). CEPA is a free trade arrangement to eliminate tariff and non-tariff barriers on trade in goods, liberalize trade in services, and facilitate investment under the principle of "one country two systems" and is consistent with WTO rules.

Before CEPA, cross border flows of goods and services are already quite free between China and Hong Kong. Hence, efficiency gains from trade in goods and services under CEPA would be positive but small. CEPA is however important in facilitate cross-border flows of people. At the present, only people from Beijing, Shanghai and Guangdong are allowed to visit Hong Kong freely under the CEPA. Already the Mainland visitors have contributed to the recovery of Hong Kong's tourist industry. More cities in the Mainland will be added to the CEPA list of free travels to Hong Kong. Hong Kong will continue to benefit from the increased pool of potential visitors. Ironically, Thailand, Singapore and



many other Asian and European cities have benefited from Chinese tourists long before the CEPA agreement was signed between Hong Kong and the Mainland.

CEPA does not address directly the issue of cross-border flows of capital. But Beijing is now studying a plan to relax its control on capital account to allow Mainland investors to buy overseas securities. A few weeks ago, Hong Kong banks were allowed to conduct limited RMB business, attracting 1.5 billion RMB deposits in the first week. Clearly Hong Kong's integration with the Mainland will be speeded up in the next few years. As Hong Kong is open to the World, this would benefit Asia and the World.

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Figure 1. Asia Team of Flying Geese

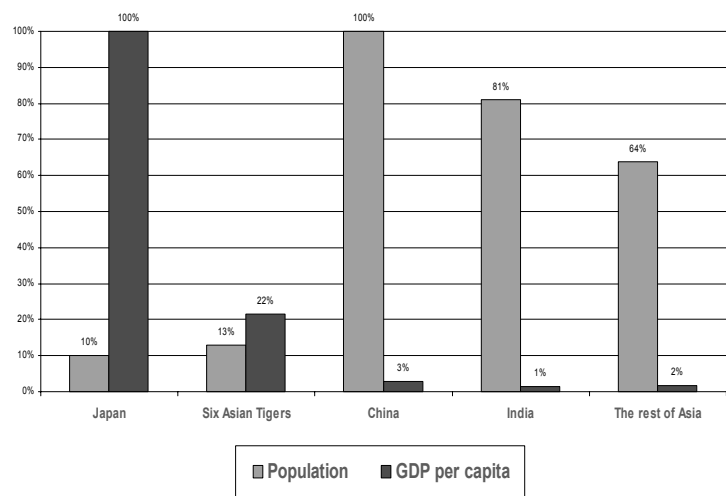
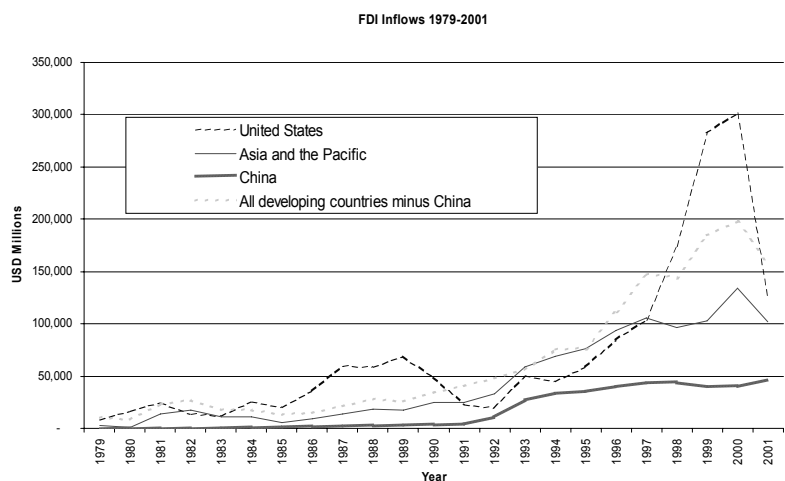


Figure 2. Global Foreign Direct Investment



Source: World Investment Report, 2002

### Figure 3. China's FDI and Export

#### Concentration of Trade and FDI in China's Coastal Provinces

| Region   | Population<br>(%) | GDP (%)      | FDI (%)      | Trade (%)    | GDP per<br>capita<br>(US\$) |
|--|-------------------|--------------|--------------|--------------|-----------------------------|
| <b>China Total</b>                             | <b>100.0</b>      | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>1,008</b>                |
| <b>Top 9 Provinces by FDI</b>                  | <b>31.7</b>       | <b>51.8</b>  | <b>84.6</b>  | <b>89.4</b>  | <b>1,647</b>                |
| E.China (Shanghai, Zhejiang, Jiangsu)          | 10.6              | 19.9         | 28.9         | 29.2         | 1,882                       |
| S.China (Guangdong, Fujian)                    | 8.8               | 14.0         | 34.2         | 40.9         | 1,600                       |
| N.China (Beijing, Tianjin, Liaoning, Shandong) | 12.2              | 17.9         | 21.4         | 19.2         | 1,477                       |
| <b>Middle 12 Provinces by FDI</b>              | <b>49.9</b>       | <b>37.4</b>  | <b>13.6</b>  | <b>7.7</b>   | <b>756</b>                  |
| <b>Bottom 10 Provinces by FDI</b>              | <b>17.7</b>       | <b>10.8</b>  | <b>1.8</b>   | <b>2.9</b>   | <b>614</b>                  |

Source: Statistical Yearbook of China, 2002.

### Figure 4. China and Asia Export

#### Share in World Exports of Manufactures 1990 and 2000

|                             | 1990          | 2000          | Gain/Loss     |
|-----------------------------|---------------|---------------|---------------|
| <b>World</b>                | <b>100.0%</b> | <b>100.0%</b> |               |
| <b>Developed countries</b>  | <b>80.4%</b>  | <b>69.4%</b>  | <b>-11.0%</b> |
| <b>Developing countries</b> | <b>17.5%</b>  | <b>27.4%</b>  | <b>9.9%</b>   |
| <b>Asia</b>                 | <b>12.6%</b>  | <b>19.9%</b>  | <b>7.3%</b>   |
| <b>China</b>                | <b>1.9%</b>   | <b>4.7%</b>   | <b>2.8%</b>   |
| <b>Asia-Six*</b>            | <b>9.1%</b>   | <b>12.2%</b>  | <b>3.1%</b>   |
| <b>Other Asia</b>           | <b>1.6%</b>   | <b>2.9%</b>   | <b>1.3%</b>   |

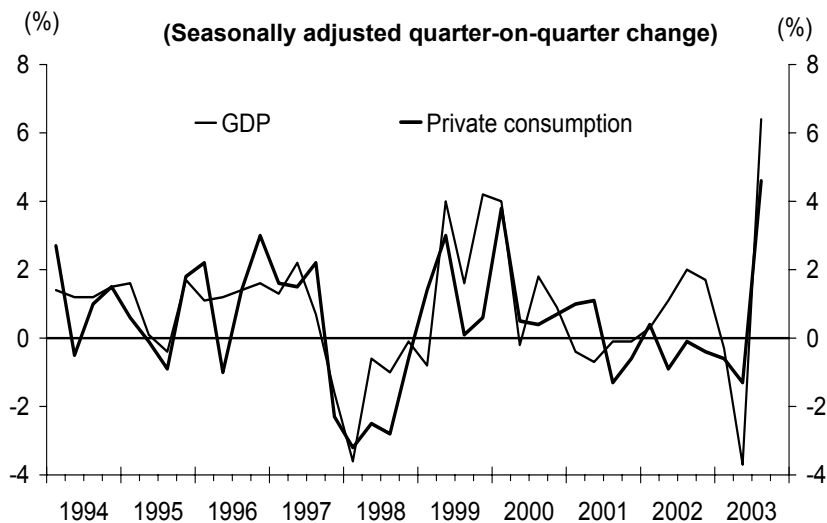
Source: WTO; \*Asia six: Taiwan, Hong Kong, Korea, Malaysia, Singapore, and Thailand; Significant re-exports excluded.

**Figure 5. China's Trade Surplus with Asia**

| China's Trade: Surplus with North America and Deficit with Aisa |              |              |                    |                        |                                    |
|---|--------------|--------------|--------------------|------------------------|------------------------------------|
| US\$ Billions   | 2001 Exports | 2001 Imports | 2001 Trade Surplus | Trade Surplus / Import | Imports grow quicker than exports? |
| World   | 266.2        | 243.6        | 22.5               | 9.3%                   | Yes                                |
| North America   | 57.6         | 30.2         | 27.4               | 90.6%                  | Yes                                |
| Europe  | 49.2         | 48.4         | 0.8                | 1.7%                   | Yes                                |
| Asia  | 141.0        | 147.2        | -6.2               | -4.2%                  | No                                 |
| Taiwan, China   | 5.0          | 27.3         | -22.3              | -81.7%                 | Yes                                |
| Thailand  | 2.3          | 4.7          | -2.4               | -50.4%                 | Yes                                |
| Malaysia  | 3.2          | 6.2          | -3.0               | -48.1%                 | No                                 |
| Republic of Korea   | 12.5         | 23.4         | -10.9              | -46.5%                 | No                                 |
| Indonesia   | 2.8          | 3.9          | -1.1               | -27.0%                 | No                                 |
| Philippines   | 1.6          | 1.9          | -0.3               | -16.7%                 | Yes                                |
| Japan   | 45.0         | 42.8         | 2.2                | 5.0%                   | No                                 |
| India   | 1.9          | 1.7          | 0.2                | 11.5%                  | Yes                                |
| Singapore   | 5.8          | 5.1          | 0.6                | 12.6%                  | Yes                                |
| Hong Kong, China  | 46.5         | 9.4          | 37.1               | 394.0%                 | No                                 |

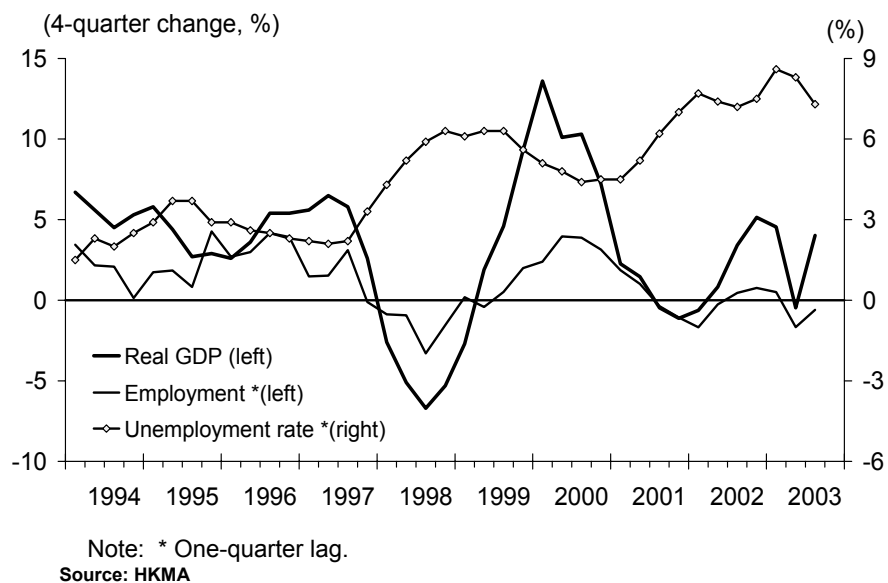
Source: Statistical Yearbook of China, 2002.

**Figure 6. Hong Kong's Business Cycle**

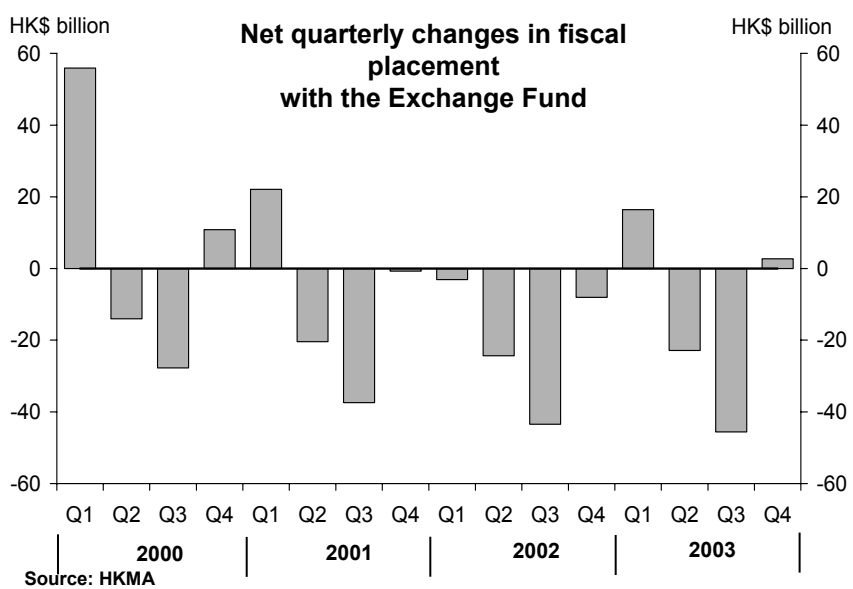


Source: HKMA

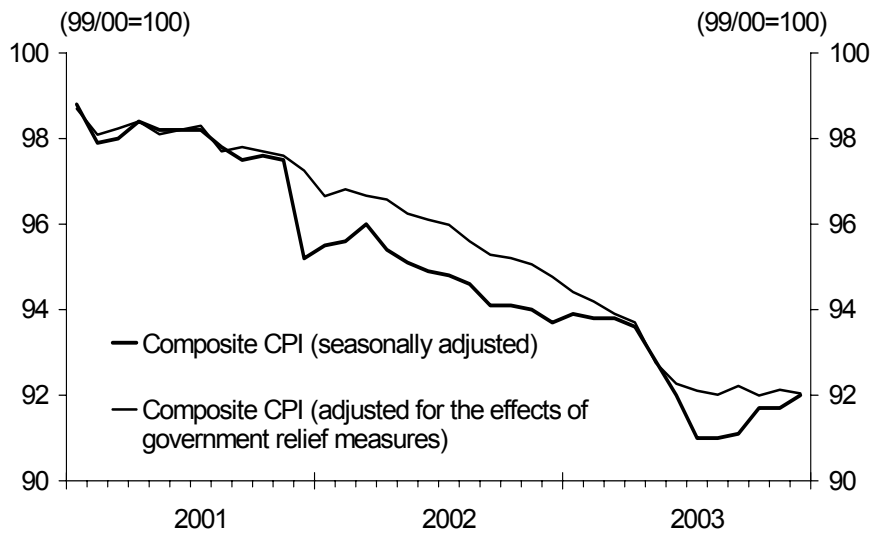
**Figure 7. Unemployment in Hong Kong**



**Figure 8. Hong Kong's Fiscal Deficits**

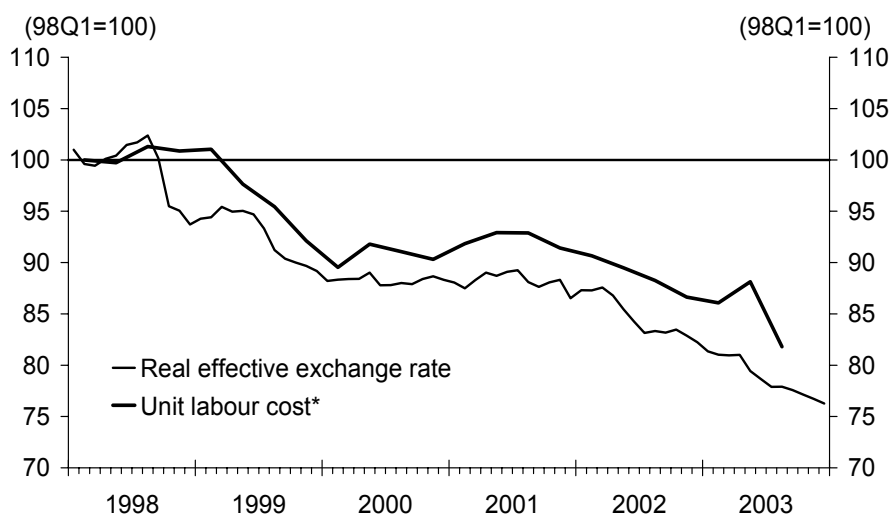


**Figure 9. Deflation in Hong Kong**



Source: HKMA

**Figure 10. Deflation Improves Competitiveness**

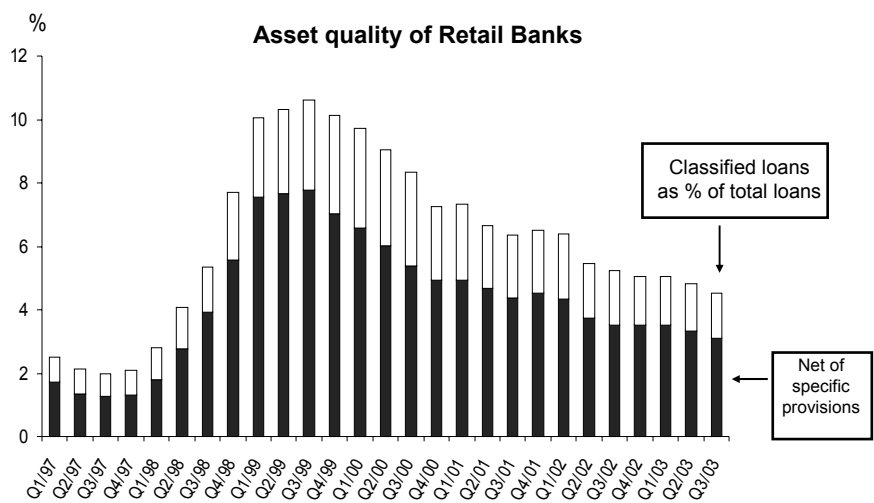


Note: \* Constructed as the ratio of total wages of all employees to real GDP.

Source: HKMA



Figure 11. NPLs in Hong Kong

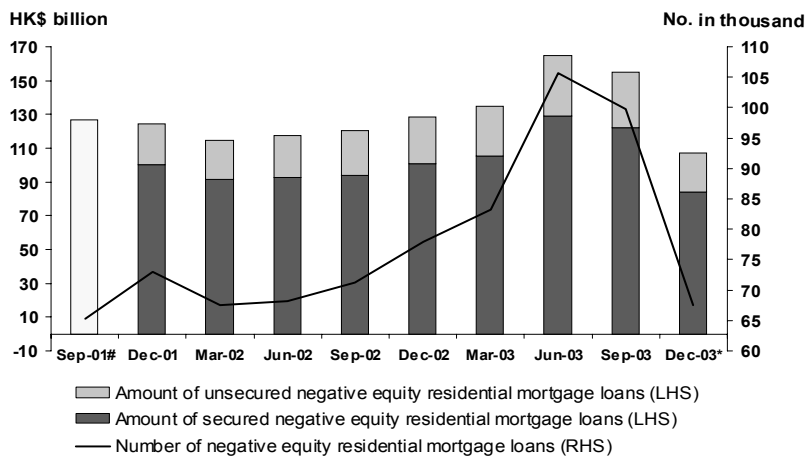


Period-end figures.

Source: HKMA

Figure 12. Negative Equity in Property

Residential mortgage lending in negative equity



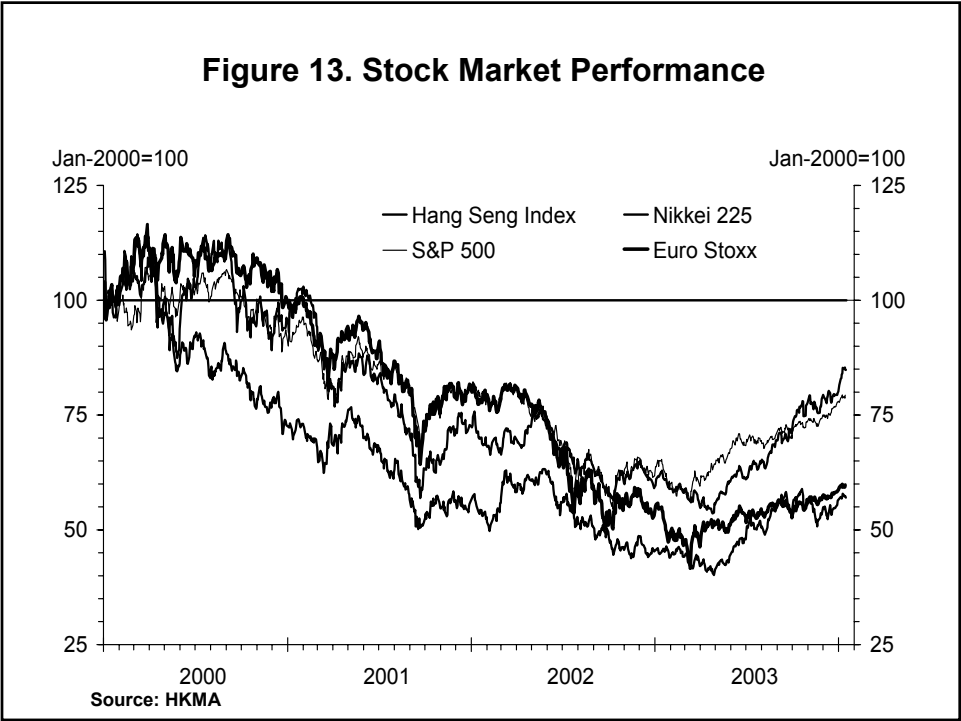
Period-end figures.

\* Preliminary figures.

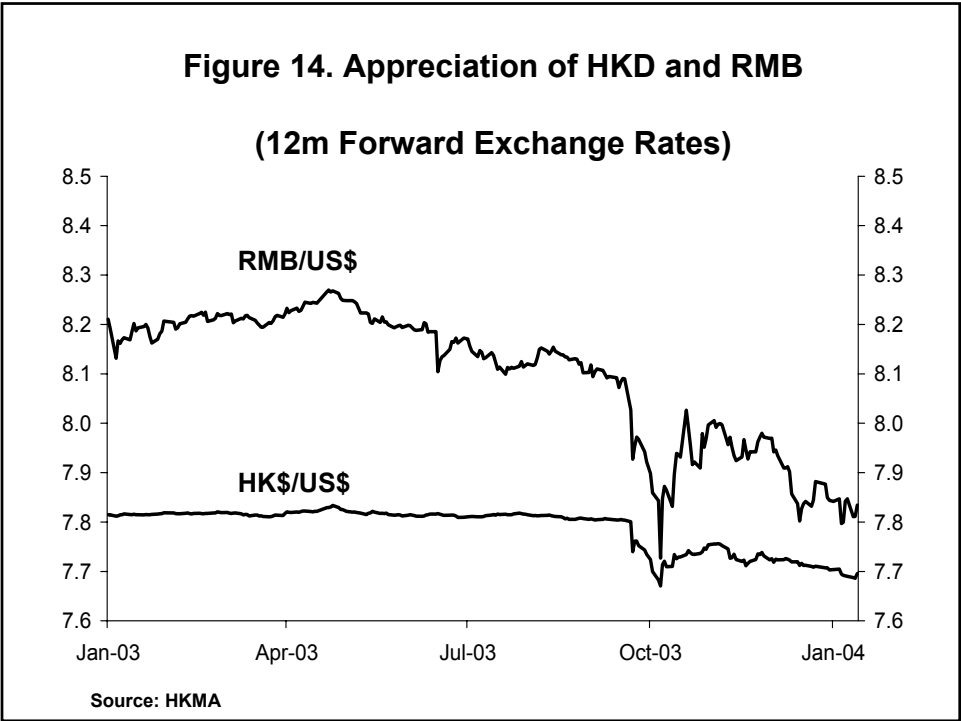
# Separate data on secured and unsecured loan value as at end-Sep 2001 are not available.

Source: HKMA

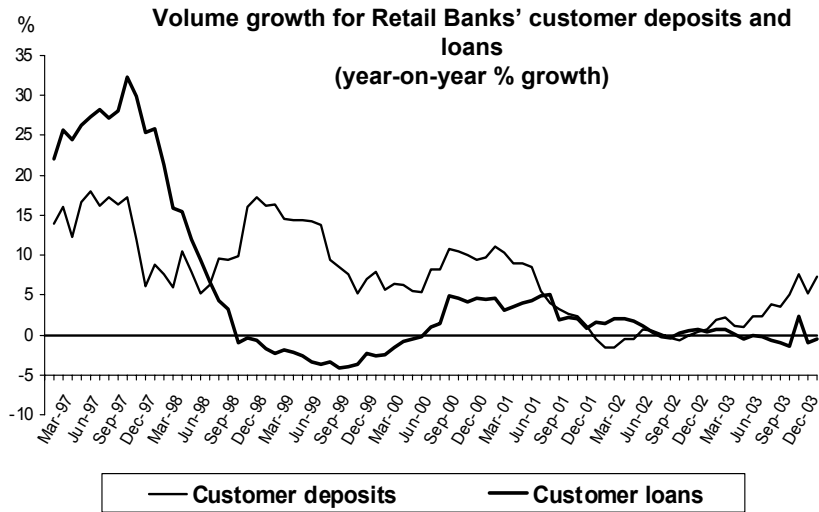
**Figure 13. Stock Market Performance**



**Figure 14. Appreciation of HKD and RMB**



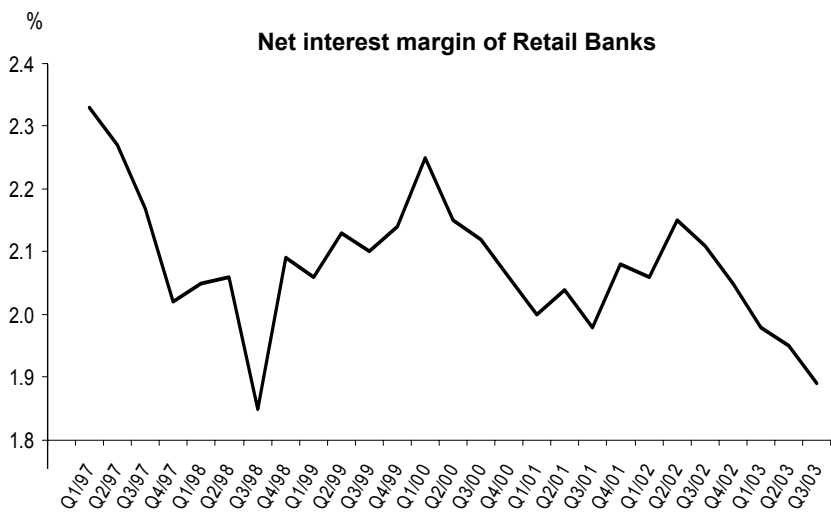
**Figure 15. Deposits and Loans**



Source: HKMA

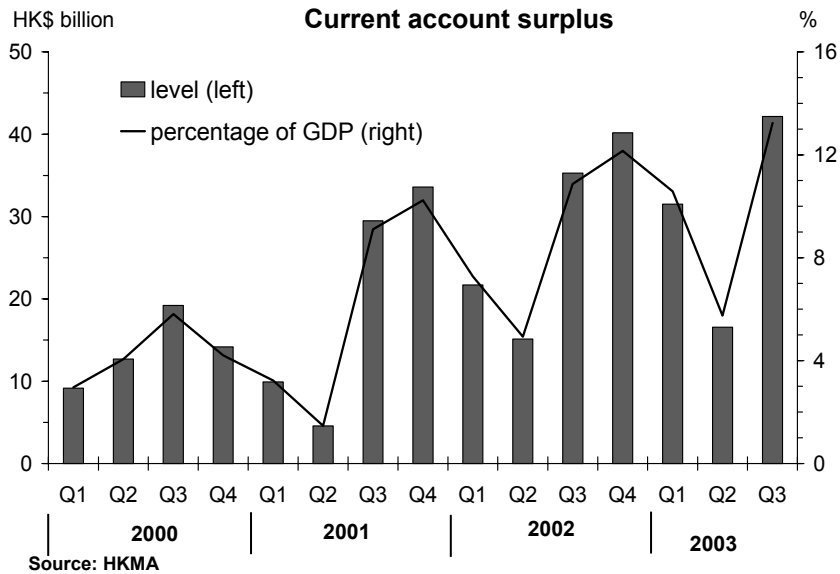
Month-end figures.

**Figure 16. Net Interest Margin**

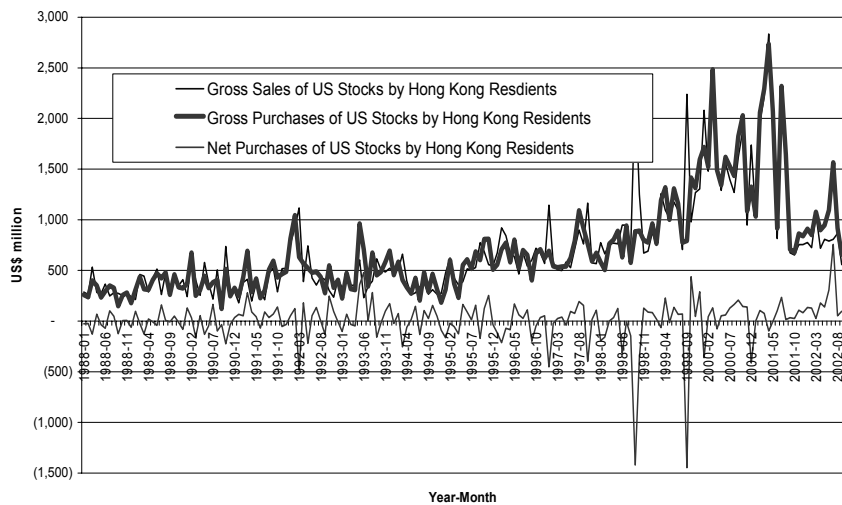


Source: HKMA

**Figure 17. Hong Kong's Exports of Savings**

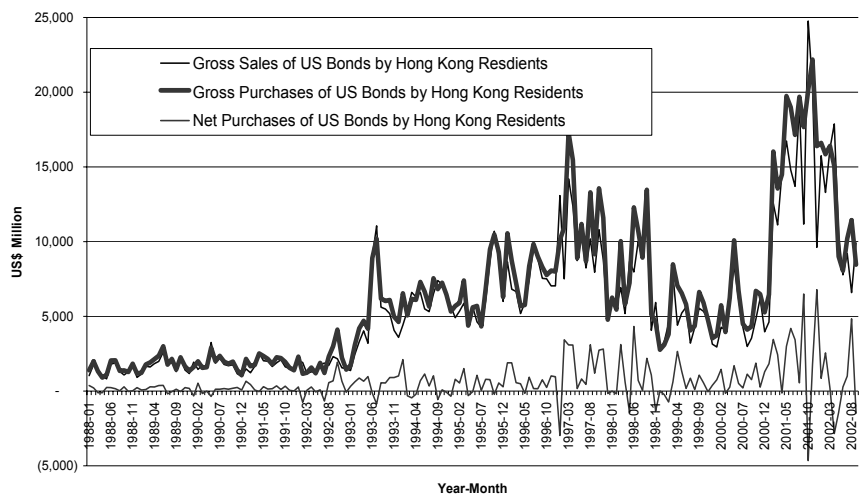


**Figure 18. Hong Kong Investment in U.S. Stocks**



Source: U.S. Treasury data.

Figure 19. Hong Kong Investment in U.S. Bonds



Source: U.S. Treasury data.